

**The Implications of the Toshiba Accounting Scandal
for Auditor Liabilities in Japan**

KHONDAKER Mizanur Rahman
School of Business, Nanzan University

Marc BREMER
Faculty of Business Administration, Nanzan University

2017年10月 NO.1704

Abstract

We discuss the enormous accounting fraud committed by Toshiba Corporation to which its auditor, Ernst & Young ShinNihon, contributed through a combination of negligence and incompetence. The auditor is responsible for a large portion of the fraud. The liability of Ernst & Young ShinNihon is analyzed. Although the auditor is responsible for the loss of billions of yen and the criminal deceit of stock owners, bankers, bond owners and other stake holders, it has faced fairly small sanctions. The monetary penalty was large by historical standards, yet quite small compared to the value destroyed. The nature of these sanctions and the logic of their calculation in the context of the damage caused has not been explained by regulators and accounting organizations. The scale of the Toshiba scandal is similar to that of the American company Enron in 2001. Arthur Andersen, Enron's auditor, was effectively destroyed by the Enron scandal. Yet, Ernst & Young ShinNihon does not face an existential liability for its contribution to the fraud. This failure to enforce consistent, proportionate and deterring liabilities means that there is no incentive to improve governance, accounting and auditing standards in Japan.

Keywords: Auditor, auditor liabilities, accounting scandal, Japan, Toshiba, window dressing

JEL classification: M40, M41, G34, G33

Acknowledgments: The authors are very grateful to Ms. Taslima Rahman and Eriko Yamamoto for their helpful comments.

I Introduction

The topic of an auditor's professional liability has received enormous attention from professional accountants, professional organizations, accounting students, accounting researchers, government bodies and international accounting organizations. All naturally take interest in this topic to promote a healthy accounting and auditing profession with a robust code of conduct. Users of accounting statements, namely business enterprises, shareholders, bondholders and creditors are interested because if they work on the basis of audited statements and thereby incur any loss, the auditor can be brought to justice and the losses recovered to some degree. Audited statements are the foundation of good investment decisions that play a vital role in the economic growth that improves human welfare.

Depending on a country's economic and industrial development, the importance of the accounting profession varies. In Australia, Canada, the United Kingdom and the United States, the accounting profession commands immense respect as well as the attention of the government and the general public. Many committees, commissions, laws and regulations define the sphere of auditors' conduct, responsibilities and obligations. Some of these codes of conduct were influenced by the many recent accounting frauds that revealed the limitations of auditor integrity. Thus, auditors must accept liability for the consequences of their actions.

Japan, the world's third biggest economy, has witnessed several frauds involving its professional accountants. Many of these scandals involved the nation's top companies and auditing firms. This is in spite of the fact that Japan possess very fine accounting regimes, accounting and auditing standards and many surveillance authorities. Window-dressing went unnoticed and undetected since regulatory regimes and protections are lax in practice. Window dressing is a misleading manipulation of accounting results; it often involves fraud. The

accounting and auditing professions are sometimes controlled by entrenched elites who shield their personal and professional interests from practical responsibility for audit failures. Recent scandals include major companies such as Kanebo, Livedoor, Olympus, Daio Seishi and Toshiba. These scandals, especially Toshiba's recent enormous misstatements shocked the nation and the business community (Third Party Report, 2011 and Mochizuki, 2015). Teikoku Data Bank (various years) reported that there were 10 publically reported window-dressing cases in 2005, 17 in 2006, 35 in 2007, 44 in 2008, 25 in 2009, 40 in 2010, 59 in 2011, 57 in 2012, 52 in 2013, 88 in 2014 and 85 in 2015. In most of the cases auditors failed to exercise due care.

These brief examples show the enormity of the problem in Japan. Most of the above mentioned scandals were made possible, or were permitted to endure, because of accounting fraud, flexible financial reporting and violations of compliance requirements. These scandals have raised serious questions from different quarters regarding the liabilities of the auditors. In view of this dismal situation, this paper examines auditors' liabilities in Japan. At first, it examines the theoretical aspects of auditors' liabilities with references drawn from the United States and South-east Asian nations. Then, it examines the legal and professional aspects of auditor liability in Japan, followed by analysis of some of the latest elements of the Toshiba scandal. The paper acknowledges that Japan's practical limits on the liabilities of auditors means that genuine improvements are unlikely. There will be many more accounting scandals. As for the research methodology, this paper is descriptive and mostly relies on secondary and archival sources.

II The Toshiba Earnings Management Scandal

Toshiba possess a proud history of more than 140 years; it was renowned both at home and abroad as an honorable member of Japan's corporate community.¹ Yet in April, 2014 the business community in Japan was astounded at the news of serious accounting fraud by Toshiba Corporation. The news likewise surprised corporate communities all over the globe, and received wide press coverage. As was reported by the *Financial Times*, "... for years, Toshiba, one of the Japan's best known electronics brands, had been a poster child of the country's efforts to police corporate behavior," and its scandal left "Japan Inc. completely shaken," and created "doubts over the nation's corporate procedures" to monitor firms as well as the internal controls of companies (Inagaki, 2015a). This accounting scandal initially involved US\$1.2 billion of earnings manipulation through window-dressing, but later ballooned up to US\$2 billion or ¥224.8 billion over the period from 2008 to 2014. Unlike an earlier scandal, this time Toshiba announced that it would conduct an all-round investigation into the accounting manipulation, its underlying causes, would take all required measures to reveal all aspects of the matter, redress all affected parties, restore goodwill, rejuvenate its management structure and repair its corporate governance.

Toshiba's operating profit was inflated by about US\$4.1 billion over the three fiscal years from April 2012 to March 2015. Initially it was claimed that the problem stemmed from abuse of an accounting procedure called "percent-of-completion," which is commonly used in long-term infrastructure projects. Under this method, sales and expenses are reported in an accounting period based on the progress made in the project (*South Coast Today*, 2015) for that

¹ In 1987, Toshiba had a serious scandal when its subsidiary, Tohibai Machine, sold computer numeric controlled milling machines to the then-Soviet Union violating an agreement that placed an embargo on selling weapons-making technology to COMECON countries. These CNC milling machines were used to produce ultra-quiet submarine propellers that upset the balance of military power during the Cold War. That scandal also involved the Norwegian company Kongsberg Defense and Aerospace (Kongsberg Vaapenfabrikk) and seriously damaged the Japan-US relationship. It resulted in the arrest and prosecution of two senior Toshiba executives and imposition of economic sanctions (Seeman, 1987). Toshiba's auditor was not implicated in the scandal.

period. More specifically, under this method the accounting treatment for contract work (total income and total cost along with the extent of the contract's progress) in a fiscal period is approximated and the income and cost of the contract for the accounting period is reported on that basis (Independent Investigation Committee or IIC/Toshiba, 2015). Of course, the approximations required by this method permit a certain degree of management discretion. Toshiba argued that its problems were caused by three projects: electricity generation, railways and related works. These projects focused excessively on reporting their assigned profit targets by lowering expenses and failed to properly adjust costs for the actual "progress" made. Further investigation revealed that the earning manipulation went further back than 2012. Toshiba executives had a direct role in falsely inflating profits for the seven years from 2008 to 2014 (Inagaki and Wells, 2015).

Toshiba manipulated its profits by more than ¥200 billion in 2008 after the bankruptcy of the US investment bank Lehman Brothers. It overstated profits for its home electrical appliance and power plant equipment businesses to win new projects after the Great East Japan Earthquake in 2011; overstated profits for electronic toll collection and overseas subway projects in 2011; overstated profits by more than ¥100 billion in its memory chip, PC and TV businesses in 2012 and overstated profits for its smart meter and overseas electrical substation projects in 2013. The investigation by the Third Party Panel (also called the Independent Investigation Committee or IIC (2015)) revealed that the accounting irregularities resulted in earning management or improper recording of profit and/or losses in fifteen projects due to systematic abuse of the percent-of-completion accounting method. Most of these abuses occurred because subservient managers feared that the chief executive would not allow the firm to report losses or that middle-managers claimed not to understand accounting principles or that management had the intent to postpone losses in the hope that future gains would offset these losses. In all these cases, the serving chief executives forced division leaders to meet profit targets in order to gain new orders or earn high operating profits (*Japan News*, 2015).

As articulated by the IIC, Toshiba had a corporate culture whereby employees cannot go or act beyond the demands of their superiors. When "challenge" targets were announced by top executives, division heads along with their subordinates were required to achieve these targets by using fraudulent accounting (IIC/Toshiba, 2015). The panel further found that the audit committee did not have internal controls as the system was dysfunctional in each division as well as at the corporate level. Although obligated to do so under customs, laws and regulations, Toshiba's auditors did not report improper accounting, nor did they report these grave deficiencies to the hapless board of directors (IIC/Toshiba, 2015).

The problem associated with the percent-of-completion method is that it requires an estimate of the total income by negotiating with the customer and the total cost of the contract work on the basis of actual cost and to quantify the actually incurred contract cost on a quarterly basis. Since the total estimated cost is determined internally, there is a risk of misstatement in terms of overstated sales or understated provisions for loss-making contracts (IIC/Toshiba, 2015).

Toshiba's failure to properly apply the percent-of-completion process to its accounting has continued to cause large problems. Even after the accounting scandal became public and was investigated by the third party panel, Toshiba continued to delay acknowledging enormous cost overruns and lack of progress at its Westinghouse subsidiary. Westinghouse is Toshiba's nuclear plant subsidiary in the United States. Westinghouse effectively failed when it could not build two large nuclear plants to schedule on a fixed-price contract. The loss was so great that when it was finally recognized in 2016, Toshiba's book value became negative. Of course this adverse development was *not* a surprise in 2016. It was simply a continuation of Toshiba's policy of denial. A proper application of the percent-of-completion accounting method would have made a provision for loss far before 2016.

III Auditors' Liabilities in Connection with Accounting Statements

There is a fundamental problem with the modern corporation as a way to organize the production of goods and services. Managers have organizational skills and far greater information about the firm's business, yet in most cases they do not have sufficient capital to build modern firms up to a size necessary to compete and capture economies of scale. They rely on the capital provided by stock owners and the resources of other stake holders to achieve this size. Stock owners have less information and organizational skill—they do not really understand what is going on inside large corporations. This gives managers the discretion to determine their own working conditions as well as the opportunity to enrich themselves at the expense of stock owners. This information asymmetry means that stock owners might not trust managers with capital leading to a mutually disadvantageous situation where investment opportunities are foregone, consumers are denied products that they want and workers fail to find employment that allows their skills to be used to the highest value. Society as whole is worse off because of the failure of trust between managers and stock owners. Auditors provide a solution to this problem by giving stock owners a believable measure of a corporation's value and check on the discretion of managers. In essence, auditors' objective measures of value solve the trust problem to make corporations creditable as recipients of investment as well as providers of goods and services. Auditors are responsible to stock owners, stake holders and broader society. Yet, in practice, managers effectively employ auditors and to some degree, auditors must please their bosses. They face enormous pressures to produce convenient financial reports.

Theoretically, auditors' offenses in connection with deceitful accounting practices such as window-dressing can be described as professional negligence, misfeasance (breach of trust or duty imposed by law) and professional misconduct for which they can be prosecuted under civil and criminal laws (Tandon, Sudharsanam and Sundharabahu, 2001, Ullah, 2001 and Gupta, 2007). Of course, financial accounting is complicated and knowledgeable professionals will disagree from time to time. Honest errors happen all too often. Yet, most accounting failures happen due to non-compliance with professional codes of conduct and ethics, failure to follow accounting and auditing standards and malicious trysts with managers. Interest in accounting failures has become more acute since the collapse of big corporations such as Enron and Worldcom (Lee, Ali and Gloeck, 2008). Toshiba is just the latest corporate hero to fail. The result is that stock owners and stake holders have largely lost trust in the audit process. The thoughts among some investors after Toshiba's collapse were along these lines: "What firm is next? Can I trust the next IPO by a firm whose auditor is Ernst & Young ShinNihon? Should I just keep my money in the post office bank?—At least the post office is safe! Gosh! My sister lost so much money on Toshiba's stock! Maybe I should sell all my stock and hide the money in a safe in the *oshiire*." The failure of Toshiba destroys goodwill, diminishes the status of other Japanese companies, and of course, undermines confidence in all Japanese accounting firms.

Accountants correctly point out that they are not heroic Sherlock Holmes-detectives; they are not responsible for identifying and solving complex crimes. Their formal duty is only to determine if the financial information *provided by managers* follows generally accepted accounting standards. Stock owners and stake holders however see auditors in a different way: auditors provide creditability. To stock owners, the auditor's statement that the firm is a *going concern* means that its financial statements capture all material aspects of the firm's condition and that they can trust that the firm has real value, and is making genuine profits. Financial report users perceive auditors' duties to include detecting and reporting frauds—far more than simply looking into compliance with statutes and audit standards (Lee, Ali and Gloeck 2008).

Thus as a practical matter, auditors assume ethical, professional and legal liabilities when scrutinizing their clients' financial statements (Ang and Lim, 2008).

Potential complaints and litigation by firms and other interested parties give rise to responsibilities which can be categorized as liabilities. The first category of liabilities arises due to professional negligence in carrying out assigned tasks and for committing misfeasance. Here for comparison, we consider auditor liabilities in South-east Asia (Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka). When sued, for example in Bangladesh, the court will investigate under the *Penal Code* or *Code of Criminal Procedure 1898 (Act V of 1889)* depending on the nature of the offense. The court will consider all principles and rules that regulate the accounting and auditing profession. The final verdict of the court, whether it is a financial penalty or professional penalty, is normally consistent with precedent (Tandon, Sudharsanam and Sundharabahu, 2001). This means that auditors have a fairly good idea of their responsibilities and the limits of their liabilities.

Under *Section 219* of the *Companies Act* in Bangladesh, the court can impose a fine in cases of negligence or misfeasance, and if the transgression arises due to non-compliance with requirements under *Section 213* (failure to access the books, accounts, and vouchers of the client, failure to make report on profit or loss and clients affairs and conformity of those with books, accounts and information received) and *Section 215* (failure to sign the audit report and any other documents as required). Similarly, for any fraudulent statement in connection with the Balance Sheet, the Statement of Profit and Loss or any supplementary statements under *Section 397* of the *Act*, the court can impose imprisonment for as much as five years (MOL/GOB, 1994). An aggrieved party can also lodge complaints with the Institute of Chartered Accountants of Bangladesh (ICAB). It is mandatory for auditors in Bangladesh to strictly observe and adhere to the guidelines mentioned in *Schedule C* of the *ICAB Ordinance* of 1973. If they fail to follow any of the rules in this law, charges for professional misconduct can be filed with the Disciplinary Committee of the Institute. In such cases, the institute may issue a warning note or may even cancel membership. This cancellation prevents the offending member from undertaking any professional activities (ICAB, 2009).

Auditors' responsibilities to third parties such as bankers, creditors, the tax authorities, equity investors and debt holders are normally categorized as liabilities for professional negligence and fraudulent practices. For professional negligence, auditors have almost no formal liability because they are not employed under a contractual relationship by the third parties. However, for fraudulent practices, they are liable if the aggrieved party can prove that the auditors' reports were materially falsified or distorted; the auditors knowingly gave such false reports; that the third party acted candidly upon the false report and incurred material losses; and, that the auditors gave their consent to include their reports with the disseminated financial statements (Tandon, Sudharsanam and Sundharabahu, 2001, Ullah, 2001 and Gupta, 2007).

The situation in the other six countries of South-east Asia is similar because they share a common legal heritage with the British judicial tradition. Accountants and auditors have civil liability for any offense relating to negligence, misfeasance and criminal liability for breach of duties under Britain's *Companies Acts*, *Penal Codes*, and its *Income Tax Acts* (Garg, 2010). Table 1 shows a summary of the various offenses that can be committed by an auditor and the associated liabilities.

Table 1: Liabilities of Auditors in South Asian Countries

Type of Offence	Type of Liability		
		To Client	To Third Parties
Negligence	Civil / Criminal	Fine / jail time	No contractual relationship and no liability
Misfeasance	Civil	Fine	Liability subject to proof and evidence
Professional misconduct	Disciplinary action	Petition filed to the Investigation and Disciplinary Committee of the ICAB which can issue warnings, withhold or cancel professional membership.	

Japan has a different legal tradition from South-east Asia; its origin is civil and German law (Bremer, Hoshi, Inoue and Suzuki, 2017 and La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1998). In Japan, the liability of the auditor to the third party is unlimited; an aggrieved party can sue the auditor and similar punishments of different degrees can be awarded. In other countries such as the United States, the auditing profession is circumscribed by tough laws, regulations and ethical codes. Many auditors purchase professional insurance to cover their professional liabilities. Such liabilities may arise under common law, securities law or the Racketeer Influenced and Corrupt Organizations Act (RICO). Table 2 summarizes auditors' liabilities in the United States (Boynton and Johnson, 2006). Reputational damage from botched audits can be fatal to an auditor. An auditor who is convicted of a felony may lose all of its clients.

Table 2: Auditor Legal Liability in the United States

Liability under Common Law	Liability under Securities Law	Other
Liability under Contract Law for breach of contract; Liability under Tort Law for fraud, gross negligence and ordinary negligence; Liability to third parties under Tort Law to all third parties for fraud and gross negligence, and to designated parties for ordinary negligence.	Securities Act of 1933 Securities Exchange Act of 1934 Private Securities Litigation Reform Act of 1995 Sarbanes-Oxley Act of 2002	Liability under Racketeer Influenced and Corrupt Organization Act of 1970

Source: Adapted from Boynton and Johnson (2006, p. 168).

Under common law in the United States, an auditor is liable to both his clients and to third parties for breach of contract when he issues a report where: he has not conducted the audit in accordance with generally accepted auditing standards (GAAS), does not deliver the report within the agreed-upon time or violates the confidential relationship with the client. The auditor is also be liable to a client under Tort Law, which can be for ordinary negligence that may occur due to failure to exercise due care as a person of ordinary prudence would under the same conditions, or gross negligence as in failing to exercise even slight care in the

circumstances or intentional deception such as misrepresentation, concealment or non-disclosure of material facts which may result in loss. Under Tort Law, the liability will be for monetary damages which have occurred to the client. The auditor is also liable to all third parties, either primary beneficiaries or other beneficiaries, for negligence and fraud under Tort Law (Boynton and Johnson, 2006).

The United States' *Securities Act of 1933* stipulates that any person or even a third party purchasing and acquiring securities can sue an auditor for losses resulting from ordinary negligence, fraud or gross negligence for false registration statements that include a material misstatement of facts in financial statements. The *Securities Exchange Act of 1934*, applies when securities are publicly traded on a national exchange or over the counter for the first time. This later law establishes the criminal liability of auditors for making willful and knowingly false and misleading statements that cause damage. Both the security buyer and seller can sue the auditor and the criminal penalty may be a fine or imprisonment. On the other hand, the *Private Securities Litigation Reform Act 1995* was intended to reduce frivolous litigation risk for auditors, publicly traded companies and parties affiliated with security issuers. This law introduces the concept of "proportionate liability" for the different parties who may be responsible for loss due to securities fraud and audit failures (Boynton and Johnson, 2006).

The *Sarbanes-Oxley Act of 2002* (SOX) has strongly influenced the auditing environment in the United States, in that it has made unlawful certain functions of auditors of public companies, for which they were formerly responsible under the self-regulatory functions of the American Institute of Certified Public Accountants (AICPA). This law gave authority to establish audit standards, quality control standards and independence standards for auditors and the right to inspect the work of public company auditors to the Public Companies Accounting Oversight Board (PCAOB). An auditor is additionally liable if his relationship with the client goes beyond the traditional role of auditing (Boynton and Johnson, 2006).

From the above description of the liabilities of auditors in selected developing and developed countries, it is clear that auditors have meaningful responsibilities to their clients and third parties irrespective of the level of economic development. Although it may seem that auditors should not have liabilities to third parties as they are not under a contractual relationship with them, yet if a third party incurs any losses due to actions based on the professional work of the auditor, the auditor cannot shake off liability. In addition to civil and criminal liabilities, the auditor is liable to his professional authority in every country. Although these liabilities may seem extreme, they are designed to establish trust in the auditing profession and to enhance its professional integrity and dignity.

IV Auditors Liabilities in Japan

Auditor liability in Japan receives its practical impetus from different national laws, regulations and professional rules. These are briefly discussed below.²

(a) Audit Board Members

Under Articles 429 and 430 of the *Companies Act*, an audit board member is liable to the company, if there is a breach of "duty of care" owed by him. Further, in cases where there is bad faith or gross negligence in performing an audit or when an audit report contains false information or does not adhere to generally accepted auditing standards, the auditor is liable to third parties who experience a material loss (Ministry of Justice/MOJ, 2005).

(b) Accounting Auditors

² Much of the information discussed here is adapted from Khondaker and Bremer (2016a and 2016b).

Theoretically, auditors' offenses in connection with false accounting practices such window-dressing are considered to be professional negligence, misfeasance and professional misconduct for which they can be prosecuted under the criminal and the civil criminal codes. Usually these result from non-compliance with codes of conduct, failure to follow auditing standards and malicious conspiracies with the management.

In the aftermath of several recent scandals, notably Kanebo and Livedoor, the Financial Services Agency (FSA) has promulgated additional regulations. In 2006, it took 163 disciplinary actions against financial institutions, which was an increase of 50 percent over the previous year. The FSA instituted these measures to enhance internal controls. These measures are nicknamed J-SOX by the Japanese media (Carozza, 2007) in reference to the nickname SOX used to refer to the American Sarbanes-Oxley Act of 2002. Like SOX, J-SOX makes clear that accountants and managers have an unambiguous responsibility to share accounting information with equity holders and stake-holders in a transparent and accurate way. In addition, Section 11 of the Japanese Companies Act of 2005 addresses the damage caused by auditors to joint-stock companies. According to Article 423 of this Section, if an accounting advisor, auditor or accounting auditor neglects his professional responsibilities, he will be liable to the company for damages arising out of the negligence (MOJ, 2005).

Theoretically, complaints and litigation by the client-firm and other parties in response to misbehavior give rise to substantial liabilities for auditors. However, in Japan the actual penalties are less severe than those in the United States. In accordance with Article 197(2) of the *Financial Instruments and Exchange Law*, the court can imprison an auditor for up to ten years and/or can impose a fine of up to 10 million yen. For a misstatement in an internal report, the penalty is imprisonment for up to five years and/or a fine of up to 5 million yen (Carozza, 2007). Table 3 shows a summary of the various offenses and liabilities under the jurisdiction of different laws in Japan (Khondaker and Bremer, 2016a). As a practical matter, actual imprisonment is rare; most prison sentences are suspended (*shikkō yūyo*). Those imprisonments that actually occur for financial crimes are for a milder version of punishment that does not require hard labor (*kinko*). The main penalty of a conviction is the devastating damage it can cause to the auditor's reputation.

Table 3: Auditor Liability in Japan

Type of Offense	Related Law	Liability
Criminal offense	Financial Instrument and Exchange Law	Maximum of ten years prison or fines of up to 10 million yen (with adjustment for personal abetment or joint offense)
Administrative punishment	Companies Law	Fine up to 1 million yen
	Financial Instrument and Exchange Law	Accepted disposal
	CPA Law	Auditor individual: reprimand, withhold practice for two year, cancellation of membership, surcharge payment Audit firm: reprimand, order to improve business management, withhold practice for two years, dissolution, surcharge payment
Civil offense	Companies Act	Liability for damage (to the audited company and third parties)
	Financial Instrument and Exchange Law	Liability for damages (investor)

An aggrieved party can also lodge complaints against an auditor or his audit firm. It is mandatory on the part of professional auditors in Japan to adhere to the guidelines of the CPA Law. If they fail to follow the rules, charges of professional misconduct can be filed against them. In such cases, the Prime Minister's office may issue a formal reprimand, cancel membership or suspend membership for up to two years. The Prime Minister's office may even seek the dissolution of the audit firm (Yamamura, 2012).

(c) Oversight by the Financial Services Agency

The Japanese CPA Act gives authority to the FSA for on-site inspections of audit firms which are members of the Japanese Institute of Certified Public Accountants (JICPA). Previously, the FSA only conducted on-site inspections for the purpose of taking disciplinary action. The CPA Act was amended in 2003 to give authority to the FSA to take administrative action against audit firms for misconduct. These disciplinary actions include suspension of business activity and revocation of permission to operate. The CPA Act was further amended in 2007 to give the FSA authority to impose fines for audit misbehavior. The fine could be equal to the audit fee when the partner of an audit firm is found guilty of negligence or equal to the audit fee plus 50 percent when the partner of the audit firm is guilty of willful misconduct. These surcharges are discretionary administrative actions by the FSA and *not* penalties imposed by the courts for criminal guilt (JICPA, 2013).

(d) Professional Ethics and Disciplinary Measures

Like other countries, auditors' professional activities in Japan are controlled and regulated by the various codes of the professional bodies with which they are affiliated. The JICPA has developed its code of ethics in conformity with that of the International Federation of Accountants (IFAC). This code of ethics prohibits certified public accountants (CPAs) from engaging in continuous multi-year audits of "large companies" as defined by the CPA Act. Specifically, this act stipulates that key audit partners of large companies must rotate at least every seven fiscal periods with a minimum of a two-year cooling off period between repeated seven-year terms. In the case of any "lead engagement partner" at the audit firm, such a partner must rotate every five accounting years at minimum. The idea is that long years of service by the same people will lead to familiarity that will compromise the objectivity of the audit process. Moreover, CPAs are prohibited from working for companies where have served as independent auditors until the end of the fiscal year following their resignation (JICPA, 2017a). The idea here is that the offer of lucrative post-retirement sinecures will compromise audit objectivity.

In Japan, a Quality Control Committee composed of three authorities, namely the JICPA, the Financial Services Agency and the Certified Public Accountants and Auditing Oversight Board (CPAAOB) work together to design and implement a quality control system for auditors in order to ensure high quality. CPA auditor firms are required to meet the quality standards set by this committee. This committee includes both JICPA members and experienced individuals from different arenas. It is responsible for developing audit quality standards, instructing and supervising review teams, approving quality control review reports and providing letters of recommendation. It forms quality control review teams to examine whether a firm's audit system meets the requirements, both on a firm-wide and on an individual engagement basis. It determines whether the system has been designed in accordance with JICPA standards, and also determines whether its quality control policies and procedures have been adequately implemented. A Quality Control Oversight Board monitors the effectiveness and independence of the overall review system based on reports submitted by the Quality Control Committee and issues recommendations (JICPA, 2017b). The CPAAOB examines reports submitted by the JICPA and carries out on-site inspections of the JICPA and audit firms. If the CPAAOB finds that the JICPA has conducted insufficient quality reviews or that an audit

firm's quality control is insufficient, it may recommend that the FSA take corrective measures. In turn, the FSA may give specific orders to CPA firms to improve their business operations (JICPA, 2017b).

(e) Auditor's Statements

Auditors do not simply follow the directives of regulators, professional associations or the various laws. Ideally, auditors appreciate their obligations to equity holders, debt holders as well as their broader responsibilities to third parties. Auditors can act on their own professional authority. They can limit their liabilities and warn stake holders by qualifying their opinion of a firm's financial reports. "Qualified" means that in the auditor's expert opinion, the firm's financial information has material misstatements, or that the auditor cannot obtain sufficient evidence on which to base an opinion, but concludes that the undetected evidence is potentially material. "Material" simply means that the amount in question is large enough to matter in the decisions of managers and stakeholders. Auditors could also express an "adverse" opinion about a financial report meaning that the firm's financial reports have material and pervasive misstatements. Auditors can also express a "disclaimer of opinion" regarding a firm's financial statements. This would be appropriate when the auditor realizes that there may be undetected material and pervasive misstatements. Auditors can also explain the degree to which the statements deviate from accounting principles.

The Toshiba scandal offers a clear example of how an auditor can fail. Toshiba's financial reports have unambiguous deviations from accounting standards. These deviations are material and pervasive. Ernst & Young ShinNihon should *not* have given an unqualified opinion of Toshiba's financial statements. Toshiba's new auditor *did* qualify its opinion of the firm's financial accounts. PricewaterhouseCoopers Aarata's opinion said that Toshiba "... should have booked a respectable degree or all" of the massive losses on its Westinghouse nuclear subsidiary in fiscal 2015 when they were overwhelmingly apparent (Kyodo News Service, 2017). Losses and provisions are not simply abstract values that can be moved to other divisions or back in time to window dress the earnings that a firm reports. Correct recognition of provisions reduces or eliminates auditor liability.

V The Fault of Ernst & Young ShinNihon with Toshiba

Accounting irregularities leading to window-dressing of financial statements mostly occur due to collusion between management and accountants as well as negligence by accountants in carrying out their audits with due diligence and professional integrity (Khondaker and Bremer, 2016b). Although Ernst & Young ShinNihon LLC is the biggest auditing corporation in Japan and was in charge of Toshiba's accounts for sixty consecutive years, it failed to carry out its duties. Its audit staff failed to detect irregularities for eight consecutive years dating back to 2008 and did not give any guidance to management for improvement and prevention. Nor did it deliberate on the matter internally. It has utterly failed in its professional auditing responsibilities and destroyed public confidence in CPAs. It is very hard to argue that the firm did not have adequate skill to recognize Toshiba's misstatements for those eight years.³

³ As a matter of speculation, it is very likely that Toshiba employees and Ernst & Young ShinNihon employees did understand that pervasive material misstatements were being reported. After all, these intelligent and highly educated people are recruited from top universities. However, their supervisors forbid that this information be released, or that accounting opinions be qualified. These employees might well be the source of the rumors of accounting problems that surfaced in 2015. These rumors may have encouraged subsequent investigations by Japan's Securities and Exchange Surveillance Commission. As such, these informal whistle-blowers limit the discretion of top management to window dress.

The improper accounting practices were persistence, pervasive and material; they should not have been difficult for Ernst & Young ShinNihon to detect.⁴ Given the sheer size of the misstatements and the gravity of the issue, the obvious question arises as to why the auditor was blind to the accounting irregularities (Waldron, 2015). This type of failure simply should not happen to a prestigious company of Ernst & Young ShinNihon's stature. Even though we note the likely collusion between Toshiba's management and its auditor, there was also unambiguous professional negligence on the part of Ernst & Young ShinNihon. Toshiba observed this (Toshiba, 2016):

For the PC Business, the Auditor, in the course of its fiscal year-end audit for fiscal year 2012, was required to conduct additional auditing procedures that would have been reasonably necessary in order to clarify the factors behind the operating profit exceeding sales in the last month of the quarter. Although the Company found that the Auditor conducted audit procedures regarding receivables from the Company's consolidated subsidiary, Taiwan Toshiba International Procurement Corp. (TTIP), it cannot be found that the Auditor obtained sufficient and appropriate audit evidence, from the perspective of performing an audit of receivables recorded on the consolidated financial statements of the Company. In this respect, it is highly possible to find that the *Auditor is responsible for negligence of duties* (italicized here and afterward by the authors).

For percentage-of-completion method projects (the electronic toll collection facilities renewal project), the auditing procedures by the Auditor to check the reasonableness of the NET (total estimated cost of contract work, etc.) in the course of its fiscal year-end audit for fiscal year 2012 were limited to matching the NET figures against the order item numbering list, and since it cannot be denied the possibility that *the Auditor neglected to perform adequate auditing procedures* to check the reasonableness of the order item numbering list figures themselves, there is a possibility of finding that *there was negligence of duties* ...

Thus, it is clear that Toshiba itself could identify negligence in the audits performed by Ernst & Young ShinNihon.

VI Punitive Actions against Ernst & Young ShinNihon

There are three surveillance authorities for professional accounting firms in Japan, namely the Japanese Institute of Certified Public Accountants, the Securities and Exchange Surveillance Commission (SESC) and the Financial Services Authority. Usually the SESC recommends punitive measures to the FSA. The FSA has issued two punitive actions against Ernst & Young ShinNihon for falsifying financial statements: firstly suspension of taking new business contracts for three months starting from January 2016, and secondly, the imposition of a fine in the amount of ¥2.1 billion or about US\$17.4 million, which was equivalent to two years of auditing fees received from Toshiba (Uranaka and Wada, 2015). The FSA identified seven accountants involved in the audit, accused them of failing to exercise due care and signing off on false financial documents. It stated that the auditing firm's operations were deeply improper, in that it failed to audit its clients with appropriate professional objectivity. The FSA discovered that one of the Ernst & Young ShinNihon's accountants spotted abnormal amounts in Toshiba's computer business, yet did not pursue the matter nor share the information with other team members. Soon after the fine was imposed, the firm announced the resignation of

⁴ It is entirely possible that Toshiba's pervasive improper accounting dates much further back. However, Japan's statute of limitations precludes investigation into these earlier fiscal periods. The statute of limitations for tax purposes is five years. For transactions with related parties, the limit is six years. The limit for criminal charges of market manipulation is seven years. And, the limit for insider trading is five years.

its chief executive, Koichi Hanabusa, and imposed a pay cut of 20-50 percent on the 19 employees involved (Inagaki, 2015b).

The SESC did not recommend punitive measures against Ernst & Young ShinNihon, rather it suggested a fine on Toshiba of ¥7.37 billion. Yet this fine was not actually imposed (Uranaka and Wada, 2015). In July 2017, the JICPA issued an order to suspend the membership of Ernst & Young ShinNihon from July 13 to September 12 under its membership provision as described in Article 50 of its constitution.

Perhaps the most meaningful punishment to Ernst & Young ShinNihon came from Toshiba. Toshiba terminated its audit contract and entered into a new contract with PricewaterhouseCoopers (PwC) Aarata from April 2016. Yet, Toshiba decided not to sue its old auditor. Toshiba has promised to review its auditing arrangements every five to seven years hereafter. This is hoped to help maintain the appropriate level of professional objectivity. Toshiba has also pledged to share information more frequently and more completely with its audit committee (*Japan News*, 2016).

A key element for the survival of an auditor is that it is trusted by managers, stock owners and other stake holders. Ernst & Young ShinNihon's failure at Toshiba could have completely destroyed this trust. If Ernst & Young ShinNihon's trustworthy reputation were destroyed, clients would terminate their audit contracts with the firm. If Ernst & Young ShinNihon was criminally convicted, firms would find it impossible to hire the company to perform audits. This is essentially what happened to Arthur Andersen when it failed to properly audit Enron in 2001. Arthur Andersen was a large American certified public accountant; it failed to detect (and perhaps conspired to hide) that Enron, a large American energy firm, had reported more than \$100 billion in revenue through systematic accounting fraud. Andersen was convicted of obstruction of justice. The conviction and other evidence of criminal conspiracy effectively destroyed the firm. Also because under American regulatory law, convicted felons cannot produce acceptable audits, the firm had to surrender its CPA licenses and the right to practice accounting in 2002.

Although Ernst & Young ShinNihon's reputation has been severely damaged, it has not been criminally convicted. Japan's accounting authorities have decided to act with great forbearance. They have handled Ernst & Young ShinNihon's failures with administrative procedures and fines. Individual employees at Ernst & Young ShinNihon have faced penalties and sanctions. Stock owners and third parties will settle their grievances with Toshiba using the civil tort law. This means that Ernst & Young ShinNihon can continue to provide audits for other firms. Employees of the firm are not likely to quit or retire early. Ernst & Young ShinNihon is still able to recruit talented staff. To the knowledge of the researchers writing this paper, no firm has dropped Ernst & Young ShinNihon as an auditor because of the Toshiba accounting scandal. Ernst & Young ShinNihon is still operating as usual.

VII Some Observations on the Issues Arising from Toshiba's Audit

Regarding Japan's audit tradition, the question is whether Ernst & Young ShinNihon followed the standards of auditing laid down for the industrial sector to which Toshiba and its different business segments belong. Toshiba as a whole belongs to the electrical and electronics industries sector, hence the obvious question is whether Ernst & Young ShinNihon followed the standards for this sector. Clearly it did not. And in spite of many years of experience, did it report the non-compliance to the JICPA? Did the JICPA and other bodies carefully investigate the quality of the audit work done for Toshiba? These questions have yet to be fully answered. Clearly the FSA levied a fine on Ernst & Young ShinNihon based on the recommendations from different related authorities. However, to all appearances, this action was a minimal *post-mortem* response that did not consider the harm that had occurred to Toshiba, its stakeholders, its governance and the corporate goodwill of Japan as a whole.

Accountants all over the world are subject to disciplinary actions and the sanctions of their affiliated bodies. In Japan, CPAs are subject to disciplinary actions of the JICPA if they commit any action that may impair the reputation of CPAs, or fail to exercise reasonable care in expressing audit opinions. Such disciplinary actions may include any of the following: reprimands, suspension of membership rights for a certain period, recommendation of withdrawal from membership, request for administrative action to the FSA to revoke the qualifications of the audit firm or other disciplinary actions (JICPA, 2017c). In addition to the disciplinary actions of the JICPA, CPAs and audit firms are also subject to actions and restrictions imposed by the FSA, which may include an order for deregistration, an order for payment of a surcharge or suspension of auditing services.

Ernst and Young Global Limited (EY), a multinational professional services group headquartered in London, is one of the largest accounting firms in the world. EY operates as a network of member firms which are separate legal entities in individual countries. Its Japanese member firm is Ernst & Young ShinNihon; it jointly provides financial services including accounting, audit, tax, consulting and other advisory services. The history of ShinNihon dates back to 1985 when it was created by a merger of Tetsuzo Ota and Showa Audit corporations. It became a member of the Ernst & Young group in 2004. As of March 2017, EY ShinNihon has 4,040 audit clients, 29 principal offices in Japan, 44 overseas offices and employs 622 CPAs (Ernst & Young ShinNihon, 2017). This firm's history and stature mean that it is completely aware of the profession's code of ethics and the system of punishments imposed for breach of ethics.

Yet after having such a long engagement with Toshiba, Ernst & Young ShinNihon overlooked persistent pervasive material misstatements and violated its own professional standards. What is more damning is that it has not received warnings either from the JICPA or from the Institute of Chartered Accountants of England and Wales (ICAEW) where its global top regulator is located. Perhaps, the JICPA did not want to take any tough punitive action against such an influential firm. The FSA imposed a three month prohibition on taking new business contracts, which is very lenient given the graveness of the problem. It surely deserved tougher punishments and sanctions from the regulating authorities.

The decision by regulators and professional organizations to treat Ernst & Young ShinNihon's failures as a non-criminal matter involves a trade-off. From a public policy perspective, it would not be good to reduce the number of auditors. A healthy competition between numerous accounting firms might raise standards, control costs and improve innovation. Further, the majority of partners and staff of Ernst & Young ShinNihon are not involved with the Toshiba misstatements. Yet allowing audit firms that sign-off on persistent, pervasive material misstatements to continue business gives extremely bad incentives. The threat of destruction of an accounting firm gives clear incentives to provide high quality audits. The wretched fate of Arthur Andersen resulted in significant improvements in governance, accounting and auditing quality in the United States. Yet the severity of the "death" penalty is so substantial that in practice, it is rarely actually applied.⁵ There is a real danger that the accounting, corporate and investment communities will conclude that Toshiba's accounting scandal was the result of a few flawed individuals. It will not lead to substantial reforms in accounting practices and corporate governance. Without meaningful reform, Toshiba-style accounting scandals will happen again.

⁵ In fact, Andersen's felony conviction was *not* a well-considered public policy decision. It may have actually been a mistake. The conviction was reversed in 2005 in the case, *Arthur Andersen LLP versus the United States*. The American Supreme Court ruled that the jury in the original case was given flawed instructions. Nevertheless, Andersen's destruction was not reversed. Subsequent to Enron, Andersen's accounting was revealed to be flawed for Waste Management Corporation, Sunbeam and one of the largest bankruptcies of modern times, WorldCom.

VIII Conclusion

From the discussion in the above sections, it is clear that Japan possesses an excellent theoretical framework to deal with the issue of auditors' liabilities in connection with all plausible parties. The four important players in this connection are the FSA, the SESC, the JICPA and the courts of law. So far, Toshiba has been held liable for its misconduct/professional negligence by the FSA, which apparently acted on the basis of recommendations from the JICPA and the SESC. However, the exact nature of the actions and deliberations of these bodies have not been well explained. This provides mixed and possible negative messages for other auditors. The two punishments so far given to Ernst & Young ShinNihon are an imposition of a fine and suspension from accepting new business contracts for three months. Of these two, the fine is substantial in terms of the amount, yet the suspension of new business contracts is insufficient, especially in view of the graveness of Toshiba's problem. The actions of the JICPA were also slow given the nature and size of the problem.

As in other countries third parties can sue auditors in Japan's civil courts. So far, no criminal cases have been initiated against Ernst & Young ShinNihon. Although it is premature to anticipate the results of future lawsuits, there is a reasonable expectation that at some point, Toshiba and its auditor will be held to account for professional negligence, misconduct and misfeasance. In the absence of criminal persecutions, significant civil court judgements or at least a potential liability that imposes an existential threat to Ernst & Young ShinNihon franchise's value, there is no incentive to improve governance, accounting and auditing standards in Japan. There will be more Toshiba-scale accounting scandals.

References

- Ang, Cheng Hock and Kenneth Tao Chung Lim. (2008). "Who Left the Gates Unlocked? Reconciling the Duties of Auditors and Company Directors," *Singapore Academy of Law Journal*, No. 20.
- Arthur Andersen versus United States* (2005). 544 U.S 696.
- Boynton, William C. and Raymond Johnson (2006). *Modern Auditing – Assurance Services and the Integrity of Financial Reporting*, 8th Edition, Hoboken, New Jersey: John Wiley & Sons.
- Bremer, Marc, Akio Hoshi, Kotaro Inoue and Kazunori Suzuki (2017). "Uncertainty Avoiding Behavior and Cross-Border Acquisitions in the Asia-Pacific Region," *Japan and the World Economy*, Vol. 41, pp. 99-112.
- Carozza, Dick (2007). "An Interview with Prof. Shinji Hatta – New Japanese Internal Control Framework: Japan Works to Deter Fraud with "J-SOX," <http://www.fraud-magazine.com/> (accessed April 4, 2015).
- Ernst & Young ShinNihon (2017). "Our Profile," <http://www.ey.com/jp/en/about-us/about-us-ernst-and-young-shinnihon-llc> (accessed July 27).
- Garg, Kamal (2010). *Bharat's Professional Approach to Advanced Auditing*, New Delhi: Bharat Law House Pvt. Ltd.
- Gupta, Kamal (2002). *Contemporary Auditing*, New Delhi: Tata McGraw-Hill.
- Institute of Chartered Accountants of Bangladesh/ICAB (2009). "Professional Misconduct," http://www.icab.org.bd/code_conduct.php (accessed December 1).
- Inagaki, Kana (2015a). "Japan Inc Left Shaken by Toshiba Scandal," *The Financial Times*, July 22.
- Inagaki, Kana (2015b). "EY's Japan Chief Quits after Toshiba Audit Fine," *The Financial Times*, December 23.
- Inagaki, Kana and Peter Wells (2015). "Record Fine for Toshiba over Profits Scandal," *The Financial Times*, September 15.

- Independent Investigation Committee or IIC, Toshiba Corporation (2015). "Investigation Report – Summary," http://www.toshiba.co.jp/about/ir/en/news/20150725_1.pdf (accessed July 25).
- Japan News, The* (2015). "Exec Pressure Incite Toshiba Fraud," July 11.
- Japan News, The* (2016). "Toshiba Wants ¥3.2 bil. from Ex-Exes – Firm Hikes Claim 10-Fold, Selects New Audit Company," January 29.
- Japan Institute of Certified Public Accountants/JICPA (2013). "Corporate Disclosure in Japan – Auditing," 5th Edition, <https://www.hp.jicpa.or.jp/english/about/publications/pdf/PUBLICATION-Auditing2013.pdf> (accessed August 28).
- Japan Institute of Certified Public Accountants/JICPA (2017a). "JICPA Code of Ethics," <http://www.hp.jicpa.or.jp/english/about/ethics/index.html> (accessed July 26).
- Japan Institute of Certified Public Accountants/JICPA (2017b). "Quality Control Review System," <http://www.hp.jicpa.or.jp/english/about/qc/index.html> (accessed August 28).
- Japan Institute of Certified Public Accountants/JICPA (2017c). "Disciplinary Actions and Sanctions on CPAs," <http://www.hp.jicpa.or.jp/english/about/actions/index.html> (accessed July 26).
- Khondaker, Rahman Mizanur and Marc Bremer (2016a). "Effective Corporate Governance and Financial Reporting in Japan," *Asian Academy of Management Journal of Accounting and Finance*, Vol. 12, Supplementary issue, pp. 93-122.
- Khondaker, Rahman Mizanur and Marc Bremer (2016b). "Accounting Irregularities at Toshiba: An Inquiry into the Nature and Causes of the Problem and Its Impact on Corporate Governance in Japan," *Global Advanced Research Journal of Management and Business Studies*, Vol. 5, No. 4, pp. 88-101.
- Kyodo News Service (2017). "Toshiba Results Contain Misstatements, SESC Staffers Say," *Japan Times* (September 25).
- La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Schliefer and Robert W. Vishny (1998). "Law and Finance," *Journal of Political Economy*, Vol. 106, pp. 1113-1155.
- Lee, Th., A Mohammed Ali, A., J.D. Gloeck (2008). "A Study of Auditors' Responsibility for Fraud Detection in Malaysia," *South African Journal of Accountability and Auditing Research*, No. 8.
- Ministry of Justice/MOJ (2005). *Japanese Companies Act (Part I, Part II, Part III, and Part IV), Act No. 86 of July 26, 2005*, Tokyo: MOJ.
- Ministry of Law/MOL, Government of Bangladesh/GOB (1994). *The Companies Act (Bangladesh), 1994*, Dhaka: MOL/GOB.
- Mochizuki, Takashi (2015). "Toshiba Profit Markdown almost Double Earlier Estimates: Japanese Company Likely to Lower Past Earnings by More than \$800 Million Due to Accounting Irregularities," *Wall Street Journal*, July 4.
- Olympus Corporation, Third Party Committee (2011). "Investigation Report Summary."
- Seeman, Roderick (1987). "Toshiba Case--CoCom-Foreign Exchange and Foreign Trade Control Revision," *The Japan Lawletter*, April.
- South Coast Today* (2015). "Editorial Roundup: The Yomiuri Shimbun – Improper Accounting, Tardy Disclosure Sparked Toshiba Share Price Plunge," <http://www.southcoasttoday.com/article/20150526/OPINION/150529697> (accessed August 3).
- Tandon, B. N., Sudharsanam, S., Sundharabahu, S. (2001). *A Handbook of Practical Auditing*, New Delhi: S. Chand & Co. (revised edition).
- Teikoku Data Bank (various years). "Survey of Corporate Bankruptcies Compliance Violations," <http://zuonline.com/archives> (accessed September 29).

- Toshiba (2016). “Notice on Decision Not to File Action Against Ernst & Young ShinNihon LLC,” https://www.toshiba.co.jp/about/ir/en/news/20160916_2.pdf (accessed August 30).
- Ullah, Wali (2001). *Auditing*, 6th Edition, Dhaka: Abadi Publications.
- Uranaka, Taiga and Takahiko Wada (2015). “Japan Fines Ernst and Young Affiliate \$17.4 Million over Toshiba Audit,” <http://reuters.com/article/us-toshiba-accounting-earnst-id/> (accessed July 26).
- Waldron, Matt (2015). “Toshiba Accounting Scandal: Should Auditor Ernst & Young ShinNihon Get a Mulligan?” <https://blogs.cfainstitute.org/marketintegrity/2015/07/28/toshiba-accounting-scandal-should-auditor-ernst-young-shinnihon-get-a-mulligan/> (accessed August 30).
- Yamamura, H. (2012). *Theory of Auditing* (in Japanese), Tokyo: Chuo Keizai.